

Insurance Insights

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Current Assumption Universal Life.....How to Fund It?

Current Assumption Universal Life (CAUL) is the “new” name for traditional Universal Life insurance. The name change is to differentiate it from Guaranteed Universal Life (GUL) which is the abbreviated name for Universal Life with Secondary Guaranteed Death Benefits. CAUL products can now offer a limited death benefit guarantee between age 80 and 90 and do build cash value in order to support the product and its premium flexibility. The GUL product will have zero cash value but can guarantee the death benefit to age 121 (lifetime), if desired. “Current Assumption” means that there is a *current* crediting rate that can change, *current* policy charges that can change, and *current* mortality cost factors that can change.

The premium for a CAUL product is only the suggested deposit based on current assumptions. Once the moving parts start to move the long term viability of the policy is impacted. CAUL promulgates its premium based on all the current assumptions. There are no neutral dollars inside the policy; dollars have pluses (interest credits) or minuses (policy charges). The problem in the CAUL product is “thin” funding a policy based on the expectation that the current assumptions are correct and will never change. Underfunding occurs when the moving parts in the policy move against the policyholder, such as a decrease in the crediting rate. Underfunding deprives the policy of interest credits and creates increased policy charges by not closing the net amount at risk gap fast enough. Note: The cost of insurance factors applied to a policy increase over time and are applied to the net amount at risk (NAR = death benefit – cash value). If the NAR does not decrease fast enough the policy charges (expenses + cost of insurance) will not be able to be supported by the premium and earnings and the existing cash value will be “tapped” to make-up the balance due, therefore, the premium has to increase or the death benefit has to decrease in order for the policy not to eventually lapse.

This is what has happened in the past with the original universal life policies; they assumed too high of a crediting rate and lapsed due to decreasing interest rates. Now we are seeing a resurgence of CAUL with somewhat of the same risks. The illustrated rates are higher than the prevailing environment can deliver.

Let’s look at an example from a large insurance carrier:

Assumptions: Male age 50
Preferred health class (excellent health)
\$1mm death benefit

The insurance company’s current crediting rate is 5.05% which promulgated a premium of \$8,547. Let’s assume after year 1 the rate decreases to 4%. You will eventually have to increase your premium to maintain the \$1 million death benefit. The amount of the increase would be determined at what age you make the adjustment. In our example, the catch up premium at age 90 is \$75,000 annually driving the IRR at age 95 from the original estimate of 3.75% (assuming level funding at 5.05%) to 1.69% (level funding assuming 5.05%)

yr.1, 4% thereafter with catch up premium paid). If the rate goes to 3% the catch up premium shows up at age 86 and the IRR at 95 goes down to .57%, and at 2% the catch up premium starts at age 80 and the IRR at 95 is (-.83%).

How to manage the funding?

Simple; illustrate CAUL using current policy charges and the minimum guaranteed interest rate which is most likely at 2% or 2.5% depending on the company and its design. This will establish baseline expectations. It will require much higher annual funding (in this case); \$17,233 vs. \$8,547! This higher funding at 2% (min. guaranteed rate) drives the IRR down to 1.07% at 95. On a relative basis, earning 1.07% in a 2% interest rate environment is better than earning 3.75% in a 5.05% rate environment. In other words, the product has huge premium penalties but maintains a fair interest rate risk split. Looking at it from another view; let's assume the client pays \$8,547 and the rate drops to 2%. The IRR at 95 with a catch up premium at 90 of \$54,000 is -.83% vs. 1.07% for the level funding at \$17,233. The same result happens at 90, 1.35% for the catch up scenario vs. 1.73% for level funding.

Let's view the scenario from the upside. If the client funds at the level premium of \$17,233 but rates stay at 5.05% they can stop paying premiums in the 11th year and the IRR at age 95 is 4.39%!

The bottom line: Funding CAUL should start with the worst case and then work backwards. Not only does it hedge downside risk but also offers upside potential as well. The reason is that there is no neutral money in life insurance. Paying more decreases the charges because the NAR is closing at a faster pace – more cash value means more interest credit rather than more dollars of NAR that are assessed policy charges. Some would call this overfunding but I call this the “correct” way to fund CAUL.

Another option, **IF** the client or agent is willing to manage the policy over the next 30 yrs. +, pick an interest crediting rate somewhere between the current and minimum interest rate and fund to that crediting rate, such as 3.5%. But then you have to manage the funding more closely if rates decrease.

I agree that funding at the higher level is more “expensive” and lowers the early years IRR. I would make three comments: First, clients do not complain when someone dies early that the product was too expensive. An early death still has an IRR that is “off the charts”. Second, thin funding is more expensive than “correct” funding if rates fall. Third, thin funding delivers less upside than “correct” funding if rates rise. Thin funding wins only if there is an early death but the mortality odds are extremely unfavorable.

My recommendation is the “correct” funding approach because it offers a superior value proposition. Aggressive sales practices do not work. Avoid the price trap, in this case paying more really is better. Whole life may deserve some consideration because it structurally requires “correct” funding and offers similar benefits as CAUL but with more guarantees and slightly less flexibility.

Moral of the story; funding for the worst case scenario delivers the best results!